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STOR

The Mexican Peso Crisis: Impact on NAFTA and Emerging Markets

By Juan R. Espana*

Mexico's 1982 announcement of its inability to service its foreign debt marked the beginning of the debt crisis of many developing countries, which for almost a decade negatively affected the growth prospects of much of the developing world. In 1994, another financial crisis in Mexico has led to a more pessimistic reassessment of the risk-return trade-off of portfolio foreign investment in developing economies, causing a temporary halt, or even a reversal of capital flows to those countries. The effects of the crisis on NAFTA and future trade agreements also are discussed.

IN **1982**, a drop in oil prices, then Mexico's main export, accompanied by a rise in U.S. interest rates, led to Mexico's declaration that it no longer could service its foreign debt. This announcement marked the beginning of the debt crisis of developing countries, plunging many of these economies into a decade-long stagnation that was finally overcome only in the 1990s.

Twelve years later, in 1994, another financial crisis in Mexico with global implications seems to threaten the growth prospects of the so-called "emerging economies," a term describing an increasingly larger group of fast-growing LDCs that have adopted market-oriented economic reforms, and that are capturing a growing share of world foreign investment.[1] Most of these countries are found in East Asia, Latin America and Eastern Europe.

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For many years, until the end of 1994, Mexico was considered a "model student" in its efforts to liberalize and modernize the economy and in the introduction of market-oriented economic policies. This special status seemed to be crowned with Mexico's 1994 entry into NAFTA, a club including two industrialized economies, Canada and the United States, and Mexico's entry into the Organization for Economic Cooperation and Development (OECD). The fact that this unexpected major crisis occurred in Mexico, in spite of its close link with the United States, has led to a serious reconsideration of the risk-return tradeoff of portfolio investment in developing economies.

The crisis might lead to the creation of new country-monitoring systems within existing international institutions and to a new approach to deal with similar crises in the future, one that allows for recovery by the affected economy, but avoids bailing out careless investors and countries failing to adopt the necessary structural reforms.[2]

EVOLUTION OF THE CRISIS

The Zapatista uprising in Chiapas, as well as several political assassinations and kidnappings of business executives combined with the rise of U.S. interest rates, made portfolio investment in Mexico less attractive to foreign investors. Persistent trade and current account deficits further undermined the stability of the Mexican currency. Facing an alarming decline in foreign reserves, the new administration of Ernesto Zedillo decided on December 20, 1994, to readjust the parity of the peso against the U.S. dollar. The intended adjustment consisted of a 13.5 percent lowering of the sliding peg around which the peso was allowed to move against the dollar.

Lack of experience and poor public relations in dealing with the currency realignment plus delays in the announcement of a credible Mexican contingency

[1] See footnotes at end of text.

plan and difficulties in crafting a U.S.-sponsored rescue package turned what was meant to be a rather minor realignment into a full-blown depreciation, with the peso going from approximately 3.3 per dollar in December 1994 to about 6.3 at the end of January, a depreciation of roughly 50 percent in one month.

Several months into the crisis, are there any signs of improvement in Mexico's external balances and economic situation? The answer is rather encouraging. After dropping to levels of approximately 8 pesos per dollar, the peso seems to have stabilized at a rate of about 6 per unit of the U.S. currency.

As a result of the roughly 50 percent devaluation implied by this exchange rate and the accompanying recession, the trade and current account deficits that provoked the crisis have, in the meantime, disappeared. Since February 1995, Mexico's trade deficit has turned into a growing surplus, presently standing at about U.S. $500 million per month. The current account deficit observed at the onset of the crisis might give place to a current account surplus for 1995.

Thus the devaluation seems to have solved the balance of payments disequilibrium as intended. However, any serious treatment of the crisis must also analyze the alternative policy options that could have been followed by Mexico in lieu of a devaluation.

MEXICAN PLANS TO DEAL WITH THE CRISIS

The crisis was unduly severe due to several factors. Once the devaluation decision was made, an immediate and well-organized public relations effort by Mexico's financial authorities would have greatly contributed to calming the fears of institutional and individual investors, reducing the extent of the inevitable outflows of capital that are to be expected in such a situation. The then Mexican finance minister Jaime Serra Puche lacked the close personal Wall Street contacts that helped his predecessor Pedro Aspe handle somewhat similar situations in the past with much more success. Another major factor was the delay by Mexico's economic team in presenting a comprehensive and credible contingency plan to deal with the crisis and to set the basis for a recovery. Finally, lack of clarity and resolve on the part of the U.S. administration contributed to aggravating the crisis further. Had the Clinton administration been willing and able to put together an aid package right after the devaluation, the extent of the crisis would have been reduced significantly.

It must be stated, however, that alternative policy options were available for Mexico in mid-December 1994.

1. Monetary discipline. Global monetarists have strongly criticized Mexico's lax monetary policy before the devaluation. Mexico's money supply was allowed to grow at an approximate rate of 20 percent during the first half of 1994 in an attempt to stimulate the economy before the August presidential elections. Later tightening of monetary policy could not undo the damage to the peso. Using a semifixed exchange rate as an anchor against inflation can be a very dangerous approach if this measure is used as a substitute for monetary discipline. A more stringent monetary policy, reducing the number of pesos in circulation, would have strengthened the Mexican currency and fully or partially avoided the crisis.
2. Another alternative would have been the introduction of a currency board, similar to the ones established by Hong Kong, Argentina, Estonia, etc.[3]
3. Given a Mexican inflation rate more than double the U.S. rate, Mexico's creeping devaluation of 0.4 pesos per day as practiced before the realignment of December 20, 1994, was not enough to prevent overvaluation of the Mexican currency vis-a-vis the U.S. dollar, thus setting the stage for Mexico's trade and current account deficits.

Even now, several months into the crisis, Mexico has not announced a currency regime for the peso. This might reflect the desire to let the peso find a comfortable level in the markets that can then be used as a point of reference for its future value, regardless of the specific regime to be adopted. It seems that the most reasonable policy in relation to the peso would be to maintain a constant real effective exchange rate, i.e., an approach that systematically adjusts the currency to take into account inflation differentials between Mexico and its trade partners, mainly the United States. One example that has been mentioned in this respect is the approach followed in Chile, where the exchange rate is regularly adjusted to reflect differences between Chilean and foreign prices. Such a system would avoid overvaluation, a common occurrence in Latin America, while at the same time providing a consistent frame of reference for the future evolution of the currency.[4]

IMPACT IN MEXICO

As mentioned before, mistakes in dealing with the crisis unnecessarily aggravated its impact and duration. The effects on Mexico have been severe: an economic contraction at a 5 percent rate is predicted for the first half of 1995, improving to a contraction at a 2 percent rate during the second half of the year and positive growth, as high as 4 percent, in 1996.

Probably the industry most affected by the crisis was the Mexican banking sector, which suffered under the combined effects of a recession and the extremely

high interest rates imposed after the devaluation as an incentive to attract foreign savings. The result was a high percentage of nonperforming loans, which negatively affected the balance sheet of many Mexican banks. In response to the crisis, the Mexican government introduced programs to assist the beleaguered banking system where a wave of mergers and cases of default are expected. A restructuring of this sector is underway, including measures permitting more foreign ownership. It is hoped that this increase will lead to liquidity as overseas institutions channel additional funds into the Mexican financial sector. Furthermore, plans have been accelerated to allow foreign investment in previously restricted areas, such as petrochemicals, real estate, airports and harbors, railroads and telecommunications.

IMPACT ON EMERGING MARKETS

In an acute case of "guilt by association," the fallout of the crisis, the so-called "Tequila effect," was felt not only in other Latin American economies such as Brazil and Argentina, but also in distant markets such as Thailand and the Czech Republic.

In general, a closer scrutiny of the risk-return trade-offs of portfolio investment in developing economies has replaced the exuberant approach of the precrisis era. The unquestioned golden opportunities of the past are now regarded in a different light, with the recognition that more careful monitoring of macroeconomic conditions in those markets is indispensable in order to avoid the excessive optimism of the past and a repetition of the Mexican case. International institutions such as the IMF and the Bank for International Settlements have been faulted for not warning of the impending crisis in Mexico. Different plans are being analyzed to set up monitoring capacities and some sort of internationally funded facility that would provide quick and sufficient assistance to countries facing a liquidity crisis like the recent one in Mexico.

All these developments will in the end also benefit the emerging economies as these will be forced to adopt sustainable economic policies, especially in relation to their foreign exchange rate, but also in relation to the role of foreign vs. domestic savings in their economic development. The Mexican case has shown that the availability of foreign savings can lead to excessive borrowing by both the public and private sectors.

ROLE OF NAFTA IN THE CRISIS

The positive expectations created by NAFTA stimulated large capital flows, especially in the form of portfolio investment, i.e. the purchase of Mexican stocks and bonds. The availability of foreign capital promoted excessive borrowing by both the public and private sectors. As confidence in the Mexican economy deteriorated, foreign portfolio investment dried up, leading to a liquidity crisis. In spite of the existence of "snap back" provisions in NAFTA (Part II, Chapter 8: Emergency Action, regarding trade restrictions, and Part VIII: Exceptions, regarding capital controls) that would allow for temporary restrictive measures to be imposed in emergency situations, Mexico stayed away from any type of protectionist policies that would have further compromised foreign investors' confidence in the irreversibility of Mexican economic reforms. Quite the contrary, Mexico accelerated plans to allow foreign participation in formerly restricted sectors. In this sense NAFTA has withstood a very important test.

One of the most important aspects of the crisis has been the *de facto* monetary cooperation between the United States and Mexico. Unlike the integration arrangements in the European Union, for instance, NAFTA does not contemplate any type of financial assistance. Nonetheless, the U.S. government put together the largest ever financial package provided to any country in history, including the largest contribution from U.S. sources and the largest credit line ever made available by the IMF to a single country. In the absence of permanent institutional arrangements, U.S. financial authorities intervened, albeit with lack of conviction at first and then only belatedly, to avoid Mexico's insolvency and the implications of such an event on world financial and trade flows.

It was in the best interest of the United States to shore up the buying power of an important trade partner, which was, until recently, the second largest buyer of U.S. goods and services. Although the bailout plan has become a controversial issue, a decisive and timely U.S. assistance package would have also helped mitigate the estimated $10 to $15 billion loss in the value of U.S.-owned financial assets of different types in Mexico.

The crisis of the peso has once again made clear that successful trade integration requires a minimum degree of macroeconomic coordination and monetary cooperation among the trade partners. If macroeconomic variables are left to diverge widely, exchange-rate fluctuations will disrupt trade flows, and cause additional macroeconomic disturbances. The current problems might revive the debate on the necessity of creating a North American Exchange Facility in the future.

On a global basis, the Mexican crisis has led to calls for an international monitoring facility, probably as part of the IMF, endowed with additional funds to deal with similar crises. Such an institution would

issue early warnings about potential imbalances in the external accounts of nations, make recommendations and financially assist those countries in distress, as long as these nations are willing to accept the stringent conditions attached to the loans. Jeffrey Sachs[5] of Harvard University has suggested giving the IMF a role similar to that of the administrator of a bankrupt company, along the lines of the chapter 11 protection contemplated in U.S. corporate law.

IMPACT OF THE CRISIS ON NAFTA'S FUTURE EVOLUTION

On January 1995 at the Summit of the Americas in Miami, President Clinton, together with the chiefs of state of other nations in Central and South America, committed themselves to the goal of creating a Western Hemisphere Free Trade Area by the year 2005. In spite of the Mexican crisis, the U.S. government has recently reiterated its firm intention to enter into free trade agreements with other countries in the Western Hemisphere. Enthusiasm for such an idea is widespread in Latin America where subregional integration agreements have progressed very rapidly,[6] especially within Mercosur, the common market association linking Brazil, Argentina, Uruguay and Paraguay, but also within the Andean Pact, a customs union comprising Colombia, Venezuela, Peru and Bolivia. Significant progress has also taken place in Central America, with the revival and strengthening of the Central American Common Market (Mercomun) and with the establishment of a web of bilateral and multilateral trade agreements now spanning all of Latin America. Such agreements include the ones signed by the Group of Three, Mexico, Colombia and Venezuela; the bilateral accords between Mexico and Central America, Mexico and Chile, etc.

Chile, which until now has not been member of any multilateral trade agreement, has started negotiations to become a member of Mercosur, by far the largest and most successful association in the area, and is expected to join that group next year. Formal negotiations between NAFTA and Chile began in May of this year, and Chile might become the next partner in NAFTA in 1996.

Whether this expansion will take place as originally planned will depend to a large extent on the evolution of the Mexican situation and whether additional associations will be perceived by the U.S. public and Congress as potential financial burdens should crises like the Mexican repeat themselves in the future.

Another factor that looms in the horizon is the possible creation of some sort of trade association between NAFTA and the European Union in what could one day become the Transatlantic Free Trade Association, TAFTA. Even though the prospects for such an arrangement are, at best, many years away, there is no reason from the point of view of economic efficiency and welfare to reject such a project out of hand. For the United States and other nations in this hemisphere, it would be convenient to accelerate integration efforts in the Americas before a Western Hemisphere Trade Association would enter into formal negotiations with the European side.

CONCLUSION

The Mexican crisis was not inevitable. Lax monetary policy and the postponement of necessary currency readjustments in Mexico combined to create a crisis situation. Assistance by the U.S. government could have limited its extent and duration had it been provided in a timely and decisive manner. In spite of the lack of formal and permanent channels to provide assistance in such a case, the United States stepped in to lend massive support to its NAFTA partner in the largest financial rescue package ever assembled for any country.

The crisis has shown, once again, that trade agreements in the case of close and important trade partners need a financial component or some sort of macroeconomic coordination. This recognition might revive the idea of establishing something like a North American Exchange Stabilization Facility within NAFTA or on a hemispheric level, financed by all the participating countries and with the participation of international institutions.

As for the future of NAFTA and its expansion to other countries in the hemisphere, much will depend on the duration and extent of the Mexican crisis. The prospect of further participants becoming another financial burden for the United States has, at least temporarily, diminished U.S. enthusiasm for further expansion. A better-than-expected recovery by Mexico from its present difficulties would certainly help revive the idea of the Western Hemisphere Free Trade Area.

On a global basis, the Mexican crisis has highlighted the inherent risks of doing business with and in emerging economies. Higher rates of growth in those countries must be balanced against higher instability, both political and financial. The Mexican crisis has led to a more realistic assessment of the risk-return tradeoffs of foreign portfolio investment in those areas of the world. The declining capital flows to developing countries since the beginning of 1994 can be expected to persist in the medium term. In the long run, the level of portfolio investment in emerging markets will depend on the rate of economic growth in those economies as well as on the continuation of political and economic reforms and their irreversibility.

FOOTNOTES

[1] According to a recent World Bank study, developing economies are expected to grow at a 6 percent rate over the next decade, double the average rate of growth in industrial economies. The share of LDCs in total foreign direct investment flows is expected to rise from 40 percent in 1994 to about 50 percent by the year 2010.

[2] As a reaction to the Mexican peso crisis, U.S. Secretary of the Treasury Robert Rubin has proposed increased monitoring by the IMF, increased pools of funds, and increased flexibility as well as conditionality in the use of those funds to cope with future crises in the future.

[3] See Steve Hanke, Kurt Schuler (1994), *Currency Boards for Developing Countries*, International Center for Economic Growth, San Francisco.

[4] For a detailed description of the Chilean approach, see the *Wall Street Journal*, February 17, 1995.

[5] *The Economist*, April 22, 1995.

[6] For a more detailed description of these subregional trade agreements, see Juan Espana, "Impact of NAFTA on U.S.-Mexican Trade and Investment Flows," *Business Economics*, July 1993.

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